

How to Solve Tax Evasion

Introduction

In the attached study, David R. Burton illustrates how to materially reduce evasion of federal taxes in the United States.

Reducing tax evasion is important because, at more than \$400 billion per year in 2006, the tax gap, which is the difference between taxes owed and taxes paid, is more than one-sixth of federal revenue. Unfortunately, 2006 figures are very likely outdated, and other experts conclude that the tax gap has likely increased significantly and is likely to continue to grow.

For example, in 2017, Richard Cebula and Fiorentina Angjellari-Dajci estimated that:

- The tax gap was \$693 billion in 2017 and will likely increase to nearly \$1.2 trillion by 2026
- The aggregate tax burden per household created by the tax gap for the 10 years ending in 2026 would be \$68,328, more than the average household income in 2015

In other words, the average American household will be working for more than one full year in the next 10 solely to pay for the surtax created by tax evaders.

Collecting the tax would materially relieve a burden currently borne by honest taxpayers and potentially restore faith in the federal government's ability to fairly collect taxes.

We encourage you to read the attached study to learn more.

The FairTax Will Materially Reduce Tax Evasion

Executive Summary

The FairTax will reduce tax evasion by at least \$38-\$52 billion per year, a 9.4% to 12.8% reduction.

Tax Evasion Problem

The existing tax gap is significant. The tax gap is the difference between taxes owed and taxes paid. At \$406 billion, the 2006 tax gap was 2.9 percent of Gross Domestic Product (GDP) or one-sixth of federal revenues.

Lower Marginal Tax Rates

Economic theory and empirical studies show that taxpayers evade taxes less when marginal tax rates are lower. The current average marginal tax rate, including payroll taxes, is approximately 37 percent. The FairTax marginal tax rate is 23 percent. Lower marginal tax rates decrease tax evasion because the incentives and rewards for cheating decline. Because of lower marginal tax rates, evasion can be expected to decline by 9.4 to 12.8 percent.

It is likely that the FairTax will reduce tax evasion by significantly more than the estimated \$38-52 billion when other factors, not quantified in this study due to lack of data, are considered. These include:

- 1) Reducing the number of collection points,
- 2) Increasing the likelihood of tax evasion being discovered,
- 3) Reducing complexity of the tax law substantially,
- 4) Increasing the clarity of penalties, and
- 5) Items 1) through 4) increasing perceived fairness.

Reducing the Number of Collection Points

The FairTax will reduce the number of tax return filers by approximately 94 percent from nearly 250 million to fewer than 15 million. Moreover, approximately 3.5 percent of all businesses account for more than 85 percent of total retail sales. These businesses are primarily large or medium-sized retailers who have very high sales tax compliance rates.

As with existing state sales taxes, the FairTax will impose tax collection at the point of sale essentially the same as income tax withholding from salary and wages. Third-party withholding has been shown to increase compliance.

Increasing the Likelihood of Evasion Being Discovered

A decrease in the number of collection points (tax filers) will increase the likelihood that tax evasion is discovered by tax authorities. The likelihood of discovery is partially a function of audit rates, which will increase because audit resources will be focused more narrowly.

Reducing Complexity

The FairTax will simplify the tax system. Any income tax has structural complexities that a sales tax does not such as depreciation, inventory accounting, qualified retirement accounts, and tracking and reporting interest income, dividends, and capital gains. None of these sources of complexity would be present under the FairTax.

Complexity increases non-compliance for several reasons. First, the sheer complexity of the tax system creates confusion so that even taxpayers who wish to comply are often non-compliant. In addition, complexity creates ambiguities that aggressive taxpayers exploit. Finally, complexity enables tax evaders to more fruitfully evade taxes by knowingly taking unwarranted positions on tax returns and then, if detected, plausibly claiming that it was unintentional.

Increasing the Clarity of Penalties

The FairTax replaces dozens of poorly understood penalties with 10 clear penalties. Clarity should improve taxpayer understanding of penalties and contribute to higher levels of compliance.

Increasing Perceived Fairness

The FairTax will likely create a greater sense of fairness that will lead to greater compliance. When taxpayers believe that other taxpayers are cheating the system and not paying their fair share, they are more likely to cheat themselves. The sense of unfairness is often a function of deliberate policy choices that are perceived as “loopholes” in an income tax system. The FairTax contains no “loopholes.” A public opinion poll conducted by Rasmussen Reports found that sales taxes are perceived as the most fair means of taxation.

Sales Tax Gaps Typically Lower

Sales tax gaps are typically lower than the federal income tax gap. For example, the California Board of Equalization estimated its sales and use tax gap at only 5.5 percent. The State of Washington Department of Revenue estimates its combined sales and use tax gap at 2.1 percent. The net federal income tax gap is about 17 percent.

About the FairTax

The FairTax replaces all federal income and payroll taxes with a national retail sales tax on goods and services.

The FairTax Will Materially Reduce Tax Evasion

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David R. Burton

This study examines the various factors that contribute to tax evasion and, based on these factors, examines the impact that the FairTax would have on tax evasion and the tax gap. In the first section, the paper discusses the existing magnitude of tax evasion and the broader tax gap in the United States and abroad. In the second section, the paper examines the primary factors that are the determinants of the level of tax evasion. Those are (1) the tax rate, (2) the penalties imposed on tax evasion, (3) the likelihood of the tax evasion being discovered, (4) the number of withholding points, (5) information sharing, (6) the perception of the fairness of the tax system and (7) the complexity of the tax system. In the third section, the FairTax is described with a particular focus on those provisions that may have an impact on tax evasion. In the fourth section, the FairTax is compared to the present tax system and the impact of replacing the current system with the FairTax is assessed. In the fifth section, a tentative assessment of the quantitative impact on tax evasion is made in light of the empirical literature.

I. Existing Levels of Tax Evasion and the Tax Gap

The “tax gap” includes revenues lost from tax evasion and from non-fraudulent tax underpayments. The Internal Revenue Service estimates that the tax gap was \$458 billion annually for the taxable years 2008-2010.¹ Cebula and Angjellari-Dajci, 2017, project that the tax gap will be as high as \$523 billion in 2018 rising to \$901 billion in 2026.²

The Gross Domestic Product (GDP) was \$13,856 billion in 2006. The gross tax gap was \$458 billion or 3.3 percent of GDP. The net tax gap was \$406 billion or 2.9 percent of GDP and 17 percent of federal revenues.³ Table 1 below shows the details of the IRS tax gap estimates.

This tax gap exists despite very significant efforts to collect taxes. 244 million tax returns were filed⁴ and 3 billion information returns were filed.⁵ These returns impose approximately \$409 billion in costs on the private sector⁶ or approximately 2.2 percent of

¹ “Tax Gap Estimates for Tax Years 2008–2010,” Internal Revenue Service, April, 2016
<https://www.irs.gov/pub/newsroom/tax%20gap%20estimates%20for%202008%20through%202010.pdf>.

² Cebula and Angjellari-Dajci, 2017, Table 5.1.

³ Estimated CY 2006 federal revenues actually collected of \$2,344 billion; derived from fiscal year data in Table 1.1, *Historical Tables, Budget of the United States Government, FY 2018*.

⁴ *IRS Data Book*, 2016, Table 2.

⁵ *IRS Data Book*, 2016, Table 14.

⁶ Scott A. Hodge, “The Compliance Costs of IRS Regulations,” Fiscal Fact No. 512, June 2016
https://files.taxfoundation.org/legacy/docs/TaxFoundation_FF512.pdf.

the Gross Domestic Product (GDP).⁷ The IRS has a budget of \$11.7 billion,⁸ employs approximately 78,000 people⁹ and imposed civil penalties of \$27.3 billion in FY 2016.¹⁰

Table 1
United States Tax Gap (2006)

Tax Gap Component	TY 2006 (\$billion, unless indicated)	Share of Gross Tax Gap (%)
Estimated Total Tax Liability	\$2,496	
Gross Tax Gap	\$458	100
Overall Voluntary Compliance Rate	81.7%	
Net Tax Gap	\$406	
Overall Net Compliance Rate	83.7%	
Nonfiling Gap	\$32	7
Individual Income Tax	\$26	6
Self-Employment Tax	\$4	1
Estate Tax	\$2	< 0.5
Underreporting Gap	\$387	85
Individual Income Tax	\$264	58
Non-Business Income	\$64	14
Business Income	\$125	27
Income Offsets	\$19	4
Filing Status	\$5	1
Other Taxes	\$1	< 0.5
Unallocated Marginal Effects	\$12	3
Credits	\$40	9
Corporation Income Tax	\$41	9
Small Corps. (assets under \$10M)	\$13	3
Large Corps. (assets of \$10M or more)	\$28	6
Employment Tax	\$81	18
Self-Employment Tax	\$65	14
FICA and Unemployment Tax	\$16	3
Estate Tax	\$1	< 0.5
Underpayment Gap	\$39	9
Individual Income Tax	\$29	6
Corporation Income Tax	\$3	1

⁷ Based on BEA data showing FY 2016 GDP of \$18,470 billion (i.e. fourth quarter of calendar year 2015 plus the first through third quarters of calendar year 2016).

⁸ *IRS Data Book*, 2016, Table 28.

⁹ *IRS Data Book*, 2016, Table 30.

¹⁰ *IRS Data Book*, 2016, Table 17.

Employment Tax	\$6	1
Estate Tax	\$1	< 0.5
Excise Tax	< \$0.5	< 0.5

Source: "Tax Gap Estimates for Tax Years 2008–2010," Internal Revenue Service, April, 2016.

Sales tax gaps that have been estimated are substantially lower. The California Board of Equalization estimated its sales and use tax gap at 5.5 percent for FY 2009-2010.¹¹ Over half of this gap is a function of unpaid use taxes. The State of Washington Department of Revenue estimates its sales tax gap at one percent and its use tax gap at 23 percent, for a combined sales and use tax gap of 2.1 percent.¹² These estimates are one-third to one-eighth the reported federal income tax gap.

Similarly, the tax gap for consumption taxes (called a value added tax (VAT) or goods and services tax (GST)) in other industrialized countries is generally lower than the tax gap associated with the U.S. income tax.

Table 2
United Kingdom – Estimated VAT Gap as a percentage of VAT Revenue

Year	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
VAT Gap	11.2%	14.4%	12.9%	11.7%	14.2%	11.6%	10.4%	10.4%	10.9%

Source: *Second Estimate of the VAT Gap for 2012-13*, HM Revenue & Customs, March 19, 2014.

Table 3
Australia – Estimated GST Gap as a percentage of GST Revenue

Year	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
GST Gap	8.3%	6.4%	6.7%	8.1%	8.2%	4.5%	7.0%	7.0%	5.8%	6.1%	6.5%

Source: Australian Tax Office, "Australian Tax Gaps," https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Prior-analysis/Australian-tax-gaps-2015-16/?page=5#Goods_and_services_tax ; Bain et al., 2015, p. 161 provide Australian Tax Office data for years prior to 2008-09 in the table above and also: 2001-02 (9.6%) 2002-03 (9.2%) 2003-04 (7.5%)

¹¹ \$2.3 billion out of \$42.2 billion due. "Addressing the Tax Gap," California Board of Equalization, Fiscal Years 2011-2012 through 2013-2014, p. 1

http://www.boe.ca.gov/meetings/pdf/P5_3_082311_Tax_Gap_2_Report.pdf .

¹² Washington State, Department of Revenue Compliance Study, Research Report #2010-4, August 20, 2010, Table 2, p. 4

https://dor.wa.gov/sites/default/files/legacy/Docs/Reports/Compliance_Study/compliance_study_2010.pdf .

Washington State Sales and Use Tax Gap (Regarding Calendar Year 2006)

	Tax Gap	Voluntarily Paid	Tax Due	Tax Gap (%)
Sales Tax	\$75,768,923	\$7,246,169,046	\$7,321,937,969	1.0%
Use Tax	89,058,203	297,610,965	386,669,168	23.0%
Total	\$164,827,126	\$7,543,780,011	\$7,708,607,137	2.1%

Thus, as reported by the respective tax agencies, the United States tax gap is more than 50 percent higher than the UK VAT gap and well over double the Australian GST gap.¹³ The most recent EU funded study of the VAT Gap found that it declined to 12.8 percent in 2015 down from 14.1 percent in 2014 and is at its lowest value since 2011.¹⁴ Again, these estimates compare favorably to the U.S. tax gap estimates. There is, however, dramatic variance among the EU countries VAT gap. [Poniatowski et al, 2017]

Consumption taxes are reported to have better compliance rates than the income tax in U.S. states and countries similar to the United States. The EU estimates, however, must be skeptically evaluated. The data and assumptions are of doubtful accuracy. The reported compliance rates jump around year to year to an implausible degree and the methodology yields implausible results. For example, the EU funded study shows a negative tax gap for Sweden (implying that Swedes systematically overpay their VAT). [Poniatowski et al, 2017] That is unlikely.

II. Factors in Tax Evasion

Tax evasion or tax fraud¹⁵ is the intentional¹⁶ failure to comply with a known legal duty to pay tax. Underpayments are not necessarily fraudulent. They may be unintentional. For example, the taxpayer may misunderstand the tax law, be unaware of certain obligations or make a computational mistake. Tax avoidance is lawful. Tax avoidance or tax planning involves structuring one's affairs so as to minimize the tax due under the law.

The magnitude of tax evasion is influenced by a number of factors. The most important factors are (1) the tax rate, (2) the penalties imposed on tax evasion, (3) the likelihood of the tax evasion being discovered, (4) the number of withholding points, (5) information reporting, (6) the perception of the fairness of the tax system and (7) the complexity of the tax system.¹⁷

¹³ $17\%/11\% = 1.54 - 1 = 54\%$ higher; $17\%/7\% = 2.43 - 1 = 143\%$ percent higher.

¹⁴ "VAT Gap," European Commission https://ec.europa.eu/taxation_customs/business/tax-cooperation-control/vat-gap_en .

¹⁵ See *Internal Revenue Manual*, 25.1.1 et seq. (Part 25, Special Topics, Chapter 1, Fraud Handbook) https://www.irs.gov/irm/part25/irm_25-001-001.html .

¹⁶ Often rendered willful or purposeful.

¹⁷ Other factors may include age, gender, education, income level, income source, "tax morale," ethics, "cultural dimensions," compliance costs, tax preparers and tax software and tax amnesties. For a survey, see Richardson (Maryann) and Sawyer, 2001 and Richardson (Grant), 2006. For a discussion of tax morale, see Luttmer and Singhal, 2014. In addition, economic actors may choose to enter the shadow economy for non-tax reasons but will then fail to pay taxes on their economic activity; see, e.g., Schneider and Enste, 2000. Changes to the tax system will generally not alter these non-tax reasons for engaging in unreported economic activity. For a discussion of the impact of "cultural dimensions," see Richardson, 2008. Cultural dimensions are described as "power distance," individualism, uncertainty avoidance, and masculinity. Power distance, in turn, is a term used to describe equal enforcement of the law across groups.

Tax Rate

As the marginal tax rate climbs, the benefit to tax evasion increases and, therefore, it becomes more likely.¹⁸ Empirical studies of tax evasion are fraught with many measurement and theoretical issues. Most such studies, however, find a positive relationship between tax rates and tax evasion.¹⁹ In other words, higher tax rates cause more tax evasion because people respond to incentives.

Penalties

As penalties increase, the cost of tax evasion increases. However, penalties can increase hostility to the tax system and foster a sense of unfairness and grievance which in turn may prompt greater tax evasion. People may try to “get their money back.” Thus, while it is generally thought that higher and more frequent penalties lead to greater compliance and less tax evasion, there is not universal agreement among researchers and the empirical findings are not uniform. There is some evidence that higher income people are more responsive to penalties.²⁰

Likelihood of Being Discovered

A higher likelihood of tax evasion being discovered by the tax authorities will decrease tax evasion. The likelihood of discovery is primarily a function of audit rates²¹ (including so-

¹⁸ There is, arguably, a theoretical ambiguity introduced if one assumes that risk aversion declines with income (see Allingham and Sandmo, 1972; Slemrod and Yitzhaki, 2002) or that penalties rise with the tax due (i.e. the penalty increases with the rate rate), Yitzhaki, 1974. There is also the price theoretic income effect (whereby higher taxes would induce greater work effort to make up for the taxes paid) in contrast to the substitution or incentive effect. See Sandmo, 2005 for a discussion of a number of other issues. For a more general economic analysis of crime, see Becker, 1968.

¹⁹ Clotfelter, 1983 (“The basic contribution of this paper is to provide econometric evidence suggesting that tax evasion is sensitive to marginal tax rates.”); Hill and Kabir, 1996 (“This article has shown that there is very strong evidence that tax rates, defined in a wide variety of ways, have significantly influenced currency demand and presumably the extent of tax-evading underground activity in Canada during the last 30 years.”); Davis and Henrekson, 2005 (“Higher tax rates on labor income and consumption expenditures lead to ... a bigger underground economy, The estimated tax effects are large for our preferred tax measures.”); Poterba, 1987 (“... a one percent increase in the marginal [capital gains] tax rate reduces voluntary compliance by between one half and one percent.”); Joulfaian and Rider, 1998 (“Our finding supports the notion that under reporting of income is positively correlated with tax rates.”); Crane and Nourzad, 1990 (“Our findings support the popular contention that evaders respond to higher marginal tax rates by increasing their evasion activity.”); Schneider and Enste, 2000 (“The analysis of causes shows that an increasing burden of taxation and social security payments, combined with rising state regulatory activities and labor market restrictions (e.g. forced reduction in working hours), are the major driving forces for the size and growth of the shadow economy.”); Cebula, 1997 (“... restraining from increasing the top marginal income tax rate may prevent further increase of the shadow economy ...”); see also Boylan et al., 2014; Ali, Cecil and Knoblett, 2001. See also Feinstein, 1991 (“... the likelihood and magnitude of evasion increases with taxpayer income and the marginal tax rate ...”). For the impact of marginal tax rates on lawful tax avoidance, see Long and Gwartney, 1987.

²⁰ “In general, compliance increases with the level of income but at a decreasing rate.” [Ali, Cecil and Knoblett, 2001].

²¹ See, e.g., Ali, Cecil and Knoblett, 2001; Cebula, 1997 (“... increased IRS audits and penalties might reduce the shadow economy ...”).

called letter audits)²² and information provided to the tax authorities either by businesses that must file information returns (e.g. W-2s and 1099s) or by other governments.

Withholding, the Number of Collection Points and Information Sharing

Tax withholding increases compliance substantially.²³ This is most obvious given the relatively low non-compliance rate with respect to wages. Employer withholding and remittance of income and payroll taxes increases compliance rates.

Reducing the number of collection points reduces tax evasion.²⁴ Given a certain level of government tax administration resources, the audit rate effectively increases because a lower number of taxpayers must be audited.

Third-party information returns increase compliance because tax authorities can easily check whether the taxpayer's reported income (or other tax item) is consistent with that reported by the third-party payor (or recipient).²⁵ In addition, such reporting reduces taxpayer errors because employers, banks, broker-dealers and others collect and report to the taxpayer the annual totals. Reporting also makes it less likely taxpayers will fail to report income or a deductible amount due to poor record-keeping or accounting. Government to government information sharing – both state to federal and vice versa and internationally – also increases compliance although it is far from clear to what degree and whether this is cost-effective.

In the aggregate, the OECD estimates that businesses in the United States collect and remit 93 percent of the taxes paid to government.²⁶ This compares to an unweighted OECD average of 79 percent.²⁷

Very little research has been done comparing the administrative out-of-pocket and economic costs of these information reporting regimes to the private sector with the tax revenue gains to government. Some, undoubtedly, are cost effective. Others are likely not to be.

²² A letter audit is when the IRS sends a letter to a taxpayer, based on third-party information returns, seeking either payment or a convincing explanation of why the proposed deficiency is incorrect. The IRS calls this the Automated Underreporter Program (AUR). In FY 2016, 3.5 million letter audits collected \$6.8 billion in revenue. Internal Revenue Service Data Book, 2016, Table 14.

²³ See, e.g., Slemrod, 2016.

²⁴ See, e.g., IMF, 2015.

²⁵ See, e.g., Slemrod, 2016.

²⁶ Milanez, 2017, Table 3.

²⁷ Ibid.

Perceptions of Fairness

People are more likely to evade taxes if they feel the tax system is unfair.²⁸ That sense of unfairness can be a function of feeling that other taxpayers are gaming or cheating the system and not paying their fair share. The sense of unfairness can also be a function of deliberate policy choices made by Congress that are perceived as “loopholes” or more fundamental structural aspects of the tax system.

Complexity or Simplicity

Complexity increases non-compliance for a number of reasons.²⁹ First, the sheer complexity of the tax system creates confusion so that even taxpayers that wish to comply will often be non-compliant. Even IRS employees and sophisticated tax preparers often (usually?) get the law “wrong” because the law is so complex. In addition, complexity creates ambiguities that aggressive taxpayers will exploit. Finally, complexity enables tax evaders to more fruitfully evade taxes by knowingly taking unwarranted positions on their tax returns and then, if detected, plausibly claiming that it was not an intentional effort to evade the tax.

Some commentators attach more importance to this factor than others. For example, Columbia law professor and former Treasury official Michael Graetz said:

“The Pollyannaish notion that compliance problems will disappear if we lower tax rates or shift from an income to a consumption tax does not withstand even cursory analysis ... [but] [b]ecause taxpayer morale is important, tax simplification may be a more promising course.” [Graetz, 1997, p. 105].

Grant Richardson found that “[c]omplexity is the most important determinant of tax evasion.” This finding is based on data for 45 countries and the results of ordinary least squares regression analysis showing that non-economic determinants have the strongest impact on tax evasion. “Overall, the regression results indicate that the lower the level of complexity and the higher the level of general education, services income source, fairness and tax morale, the lower is the level of tax evasion across countries. These findings remain robust to a broad range of cross-country control variables, an alternative tax evasion measure and various interactions.” [Richardson, 2006]

Using survey data, other researchers came to different conclusions. “Our empirical results suggest that simplifying the United States income tax system may not be an effective deterrent to income tax evasion, at least based on taxpayer attitude surveys. We found no systematic links between perceptions of complexity and perceptions of unfairness.” (Forest and Sheffrin, 2002).

²⁸ See, e.g., Forest and Sheffrin, 2002 (“We generally found that increased perceptions of fairness led to improved compliance.”).

²⁹ See, e.g., Richardson, 2006, Schneider and Neck, 1993.

III. The FairTax

The FairTax repeals the individual and corporate income tax, payroll taxes and the estate and gift tax. The Fairtax imposes a 23 percent sales tax on sales of goods and services to consumers.³⁰ The tax base is comprehensive. All consumption goods and services sold in the U.S. are taxed. Consumers that personally import goods into the U.S. must pay the 23 percent tax. The FairTax does not impose taxes on business to business transactions (including exports).³¹

All households receive a prebate paid monthly in advance equal to the sales tax rate times the poverty level divided by 12. An additional amount is provided to married couples to prevent a marriage penalty since the HHS poverty level³² for a household of two persons is not two times the HHS poverty level for one person. This provides an amount of annual tax-free consumption shown in Table 4.

Table 4
FairTax Annual Family Consumption Allowance

Number of Persons in Household	Married Couple	Single
1		\$12,060
2	\$24,120	\$16,240
3	\$28,300	\$20,420
4	\$32,480	\$24,600
5	\$36,660	\$28,780
6	\$40,840	\$32,960
7	\$45,020	\$37,140
8	\$49,200	\$41,320

The number and complexity of penalties is dramatically reduced. Instead of dozens of complex and overlapping penalties, the FairTax has ten penalties. The severity of the penalties imposed is somewhat reduced compared to present law. The penalties are graduated so that there is a continuing incentive to comply. Both civil and criminal penalties are provided.

The penalties include:

1. Failure To Register, Reckless or Willful Failure to Collect Tax;
2. Reckless or Willful Assertion of Invalid Exemption;
3. Reckless or Willful Failure to Remit Tax Collected;
4. Reckless or Willful Failure to Pay Tax;

³⁰ The FairTax Act of 2017. H.R. 25 (115th Congress); S. 18 (115th Congress).

³¹ In other words, the tax does not cascade and is a destination principle consumption tax.

³² Annual Update of the HHS Poverty Guidelines, *Federal Register*, Vol. 82, No. 19, January 31, 2017, pp. 8831-8832. <https://www.gpo.gov/fdsys/pkg/FR-2017-01-31/pdf/2017-02076.pdf>.

5. Penalty for Late Filing;
6. Penalty for Willfully or Recklessly Accepting a False Intermediate or Export Sales Certificate;
7. Penalty for Late Remittance of Taxes;
8. Penalty for Filing False Rebate Claim;
9. Penalty for Failure to Maintain a Separate Segregated Account; and
10. Penalty for Failure to Deposit Collected Taxes in a Separate Segregated Account.³³

IV. The Impact of the FairTax on Tax Evasion

The FairTax can be expected to substantially reduce tax evasion. It would reduce marginal tax rates, increase the likelihood that tax evasion would be detected, reduce complexity, impose substantial third-party withholding and increase perceived fairness. All of these factors will tend to reduce tax evasion.

Substantially Lower Marginal Tax Rates

The FairTax dramatically lowers marginal tax rates for most taxpayers. Even a wage-earner in the lowest 10 percent income tax bracket today must also pay payroll taxes (a total of 15.3 percent).³⁴ Thus, the effective marginal tax rate on even low-income workers is 25.3 percent. If the phase-out of the earned tax credit is considered, this rate is 21.06 percent higher.³⁵ It is a combined 37.3 percent for many middle-income taxpayers. Higher income taxpayers face a 39.9 percent combined tax rate.

According to the National Bureau of Economic Research TAXSIM model using IRS Statistics of Income, the average marginal income tax rate under present law is approximately 26 percent.³⁶ Payroll taxes would increase that average marginal tax rate by approximately 10.6 percent to a combined 36.6 percent.³⁷

Under the FairTax, the marginal tax rate for all taxpayers is 23 percent. Thus, the FairTax would reduce marginal tax rates from approximately 36.6 percent to 23 percent or by 37.2 percent. Effective tax rates under the FairTax can be negative for those spending less than the poverty level and gradually (and asymptotically) approaches 23 percent.

³³ Proposed Internal Revenue Code §504 of §201 of H.R. 25 (115th Congress).

³⁴ Whether the employer or employee nominally “writes the check” or has a statutory obligation to pay does not matter. The economic incidence or burden of the payroll tax is primarily on workers.

³⁵ Internal Revenue Code §32(b).

³⁶ “Summary Measures of the US Income Tax System, 1960 – 2016, Marginal and Average Tax Rates and Elasticities, National Bureau of Economic Research <http://users.nber.org/~taxsim/alllyup/ally.html>.

³⁷ Approximately 65.8 percent of covered wages are subject to the Social Security (12.4 percent) and Medicare (2.9 percent) payroll tax; 16.8 percent of covered wages are subject to only the Medicare payroll tax and of the remaining 17.4 percent, approximately half is subject to the 0.9 percent Obamacare tax. A weighted average marginal tax rate of 10.6 percent was calculated accordingly. For data, see 2017 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds (Table V.F.2) and 2017 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds (tables III.B.5 and VI.G.6 and p. 144).

Since the empirical evidence discussed above shows that reducing marginal tax rates reduces tax evasion, the FairTax can be expected to substantially reduce tax evasion. Tentative quantitative estimates are provided in section V below.

Penalties

The FairTax maintains penalties for non-compliance but reduces their severity somewhat compared to present law. It also replaces dozens of different and poorly understood penalties with ten clear penalties. This clarity should improve taxpayer understanding of the penalties they are likely to face and contribute to higher levels of compliance. The penalties are graduated and provide an incentive for continuing compliance. The legislation provides for both civil and criminal penalties.

Increased Likelihood of Detection

Although it is a bit difficult to determine in advance the precise number of businesses that will file sales tax returns, Census Bureau and IRS Statistics of Income data can provide a rough idea. By far the most important unknown factor when estimating the number of filers under the FairTax is estimating what proportion of businesses without an employee (i.e. independent contractors) will sell to consumers and, therefore, be required to collect and remit sales tax. However, because these sole proprietorships account for a small proportion of overall sales, their impact on tax evasion is limited. Many independent contractors have one or a few businesses with whom they contract. Other sole proprietors serve the public. There are roughly 6 million employers in the United States and 24 million non-employer establishments (overwhelmingly sole proprietor independent contractors). A reasonable estimate is that there will be about 14 ½ million filers (between 2/5ths and ½ of the number of business filers under current law). See Table 5.

Table 5
Estimated Number of Filers under the FairTax

Sector	Number of Non-employer Establishments (A)	Number of Employer Firms (B)	Percentage Filing (C)	Estimated Number of FairTax Filers (D) ³⁹
Total for all sectors	24,331,403	5,900,731		14,465,163
Agriculture, forestry, fishing and hunting	236,094	21,676	25%	64,443
Mining, quarrying, oil and gas extraction	98,134	22,073	0%	
Utilities	19,968	5,898	75%	19,400
Construction	2,430,014	669,227	25%	774,810
Manufacturing	355,467	251,774	25%	151,810
Wholesale trade	417,272	307,059	0%	
Retail trade	1,985,553	652,418	100%	2,637,971
Transportation and warehousing	1,528,264	179,447	25%	426,928
Information	328,995	74,200	25%	100,799
Finance and insurance	718,472	237,408	25%	238,970
Real estate and rental and leasing	2,635,780	291,372	50%	1,463,576
Professional, scientific, technical services	3,410,855	799,986	25%	1,052,710
Waste management & remediation services	2,069,144	335,848	50%	1,202,496
Educational services	710,383	90,166	50%	400,275
Health care and social assistance	1,978,850	657,190	75%	1,977,030
Arts, entertainment, and recreation	1,341,733	122,874	75%	1,098,455
Accommodation and food services	371,413	517,805	75%	666,914
Other services (except public administration)	3,695,012	682,143	50%	2,188,578

Source: Census Bureau, 2015 SUSB Annual Data Tables by Establishment Industry, Number of Firms, Number of Establishments, Employment, and Annual Payroll by Large Enterprise Employment Sizes for the United States, NAICS Sectors: 2015 (release date: 9/29/2017) https://www2.census.gov/programs-surveys/susb/tables/2015/us_6digitnaics_2015.xlsx; Census Bureau, Nonemployer Statistics by Legal Form of Organization for the U.S. and States: 2015 https://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=NES_2015_00A1&prodType=table .

³⁹ Column C times the sum of column A and column B.

Table 6
Current Law Business Filers (2013)

C Corporations	1,611,125
S Corporations	4,257,909
Partnerships (including LLCs)	3,460,699
Nonfarm Sole Proprietorships	24,074,684
Total	33,404,417

Source: Internal Revenue Service, Statistics of Income, Table 1. Number of Returns, Total Receipts, Business Receipts, Net Income (less deficit), Net Income, and Deficit by Form of Business Tax Years 1980-2013

<https://www.irs.gov/pub/irs-soi/13otidb1.xls> .

Under the Fairtax, the likelihood that tax evasion would be detected would increase because audit resources can be focused more narrowly. The number of collection points is reduced dramatically. Fewer than one percent of firms (the roughly 43,000 firms with receipts over \$50 million annually) account for more than three-quarters of all sales.⁴⁰ 198,000 firms account for 86 percent of all sales.⁴¹

Table 7
Sales Concentration

Enterprise Receipt Size	Number of Firms	Estimated Receipts (\$1,000)	Percentage of Total Receipts	Percentage of Firms
<100,000	1,160,026	55,794,012	0.20%	20.30%
100,000-499,999	2,288,643	583,670,348	1.80%	40.00%
500,000-999,999	878,945	621,580,972	1.90%	15.30%
1,000,000-2,499,999	733,402	1,139,446,404	3.50%	12.80%
2,500,000-4,999,999	298,715	1,042,242,152	3.20%	5.20%
5,000,000-7,499,999	110,951	675,067,243	2.10%	1.90%
7,500,000-9,999,999	57,463	496,274,607	1.50%	1.00%
10,000,000-14,999,999	60,995	740,762,561	2.30%	1.10%
15,000,000-19,999,999	31,500	542,676,132	1.70%	0.60%
20,000,000-24,999,999	20,160	449,120,345	1.40%	0.40%
25,000,000-29,999,999	13,523	369,676,930	1.10%	0.20%
30,000,000-34,999,999	9,860	319,100,052	1.00%	0.20%
35,000,000-39,999,999	7,362	275,063,826	0.80%	0.10%
40,000,000-49,999,999	10,633	474,302,463	1.50%	0.20%
50,000,000-74,999,999	14,490	882,089,089	2.70%	0.30%
75,000,000-99,999,999	7,100	611,676,158	1.90%	0.10%
100,000,000+	22,392	23,359,266,683	71.60%	0.40%
Total	5,726,160	32,637,809,977	100.00%	100.00%
50,000,000+	43,982	24,853,031,930	76.10%	0.80%
10,000,000+	198,015	28,023,734,239	85.90%	3.50%

Source: Census Bureau, 2012 SUSB Annual Data Tables by Establishment Industry Number of Firms, Number of Establishments, Employment, Annual Payroll, and Estimated Receipts by Enterprise Receipt

⁴⁰ See Table 7 below.

⁴¹ Ibid.

Sizes for the United States, All Industries: 2012 https://www2.census.gov/programs-surveys/susb/tables/2012/us_6digitnaics_r_2012.xlsx .

Under the current system, 244 million tax returns were filed in FY 2016.⁴² About 33 million of these were business tax returns.⁴³ In addition, 3 billion information returns were filed in FY 2016.⁴⁴

Under the FairTax, individuals will generally not need to file tax returns unless they are sole proprietors of a business or directly import goods into the United States. There will be roughly 14 ½ million businesses filing tax returns under the FairTax. Thus, the FairTax will reduce the number of tax return filers by approximately 94 percent.⁴⁵ In addition, the 3 billion information returns will no longer need to be filed. Strikingly, approximately 200,000 businesses (with receipts over \$10 million annually) will account for an estimated 86 percent of sales.⁴⁶

In order to receive the FairTax prebate, households would be required to file a simple information return. Filing the information return is not required but failure to file the information return means the prebate will not be paid. There are approximately 126 million households in the U.S.⁴⁷ These information returns would require the following information:

- (1) the name of each family member who shared the qualified family's residence on the family determination date,
- (2) the Social Security number of each family member on the family determination date who shared the qualified family's residence on the family determination date,
- (3) the family member or family members to whom the family consumption allowance should be paid,
- (4) a certification that all listed family members are lawful residents of the United States,
- (5) a certification that all family members sharing the common residence are listed,
- (6) a certification that no family members were incarcerated on the family determination date (within the meaning of subsection (1)), and
- (7) the address of the qualified family.⁴⁸

Neither income or consumption level is relevant to the prebate amount. The Social Security numbers of recipients are easily checked to ensure that only one prebate is paid with respect to any individual.

Third Party Withholding

⁴² IRS Data Book, 2016, Table 2.

⁴³ See Table 6.

⁴⁴ IRS Data Book, 2016, Table 14.

⁴⁵ $14.2/244 - 1 = -94$ percent.

⁴⁶ See Table 7.

⁴⁷ Households, by Type, 1940-Present, Census Bureau <https://www2.census.gov/programs-surveys/demo/tables/families/time-series/households/hh1.xls>.

⁴⁸ Proposed Internal Revenue Code §302(d) of §201 of H.R. 25 (115th Congress).

Third party withholding has been shown to increase compliance.⁴⁹ The quantitatively most important withholding under current law is withholding of income and payroll taxes on wages and salaries. Withholding is also used with respect to certain payments of dividends and interest for which the payor does not have a valid taxpayer identification number for the payee and for certain foreign payees.

Under the FairTax, most transactions would be subject to withholding at the point of purchase by the seller, much as wages are subject to income tax withholding by the employer under current law. A relatively small number of businesses, about 200,000, account for 86 percent of sales. This aspect of the FairTax will have a salutary impact on tax evasion rates.

Substantially Reduced Complexity

Complexity will decline considerably under the FairTax.

The FairTax is dramatically simpler than the current income tax system. *Any* income tax has structural complexities that a sales tax does not. Major sources of complexity in any income tax include capital cost recovery (depreciation) rules, inventory accounting, qualified plan rules (governing retirement accounts), and income sourcing, expense allocation and related-party intercompany pricing rules (for purposes of international taxation). None of these sources of complexity would be present under the FairTax. The income tax requires tracking and reporting financial transactions including interest income and expense, dividends, capital gains and other financial transactions that are not relevant to determining tax liability in a sales tax. This is a huge simplification.⁵⁰ In addition, the current tax system is full of tax preferences that the FairTax would repeal. As mentioned above in the previous section, the number of tax returns filed will decline by 94 percent and billions of information returns will no longer be necessary.

The use tax issue, a source of concern for state sales taxes, is relatively minor problem with respect to the FairTax because few consumers directly import goods from without the United States and the tax on direct consumer imports would be enforced by U.S. Customs and Border Protection together with customs duties at the border. There are no comparable border formalities between states.

Perceived Fairness

⁴⁹ See, e.g., Slemrod 2016.

⁵⁰ This is sometimes called using an R type (real) tax system instead of an R + F type system (real plus financial). See Meade, 1978. A sales tax is an R type system.

There is relatively little hard information about the perceived fairness of a sales tax compared to the income tax. One public opinion poll has found that the sales tax is perceived as the most fair means of taxation.⁵¹

FairTax versus a Value Added Tax

A value added tax and a retail sales tax are economic equivalents. They both tax consumption and a “pure form” value added tax would tax all consumption just as a “pure form” retail sales tax would tax all consumption. They are both destination principle taxes. The difference is how the tax is administered. A retail sales tax exempts intermediate sales or inputs, taxing only final sales to consumers. A value added tax taxes all sales, including final sales to consumers, but provides a credit for taxes paid on intermediate sales or inputs. In a VAT, a border tax adjustment taxes imports and rebates the tax paid on exports. A sales tax simply doesn’t tax exports and taxes imports when they are sold to consumers in the United States. For the purposes of this paper, the question is whether the administrative differences between the two taxes has an important impact on tax evasion and whether those designing or administering a U.S. sales tax have lessons to be learned from other countries’ experience with credit-invoice VATs.

Large amounts of ink have been spilled by U.S. public finance economists writing about the “self-enforcing” nature of a value added tax⁵² and that a sales tax over 10 percent can’t be enforced.⁵³ Both of these claims reflect naiveté, analytical failures, an unfamiliarity with the non-U.S. public finance literature and an apparent unawareness of actual experience with the administration of actual value added taxes in other OECD countries.

An extended quotation from an International Monetary Fund working paper entitled “VAT Fraud and Evasion: What Do We Know, and What Can be Done?” [Keen and Smith, 2007] is in order.

Moreover, while traders have an incentive to ensure that their suppliers provide them with invoices that the authorities will accept as establishing a right to refund or credit, they have no incentive—unless specific requirements to this end are imposed—to ensure that tax has actually been paid: for this reason, as Hemming and Kay (1981) stress, the notion that the VAT is self-enforcing is ultimately ‘illusory.’ The point will be of some importance below. Furthermore, the credit and refund mechanism of the VAT creates its own opportunities for fraud, as we now discuss.

⁵¹ “Americans Say Sales Tax Fairest of Taxes,” Rasmussen Reports, September 13, 2017 http://www.rasmussenreports.com/public_content/business/taxes/september_2017/americans_say_sales_tax_fairest_of_taxes .

⁵² See, e.g., James M. Bickley, “A Value-Added Tax Contrasted With a National Sales Tax,” Congressional Research Service, September 30, 2004, “Enforcement” at p. 3 https://digital.library.unt.edu/ark:/67531/metacrs6044/m1/1/high_res_d/IB92069_2004Sep30.pdf .

⁵³ Ibid, “Maximum Tax Rate” at p. 3; “What is the experience of other countries with national retail sales taxes?,” *Tax Policy Center Briefing Book* <http://www.taxpolicycenter.org/briefing-book/what-experience-other-countries-national-retail-sales-taxes> .

...

In terms of commodity taxation, the natural comparator in the United States context is the RST. Hard evidence on the extent of noncompliance with the state sales taxes is surprisingly sparse, but the review in Fox and Murray (2004) tends to confirm a conventional wisdom that it is quite modest (at about 1.3 percent in Washington state, for example). ... But the apparent modesty of the sales tax gap reflects the generally low level of rates (though that in Washington, at 6.5 percent, was by U.S. standards relatively high). And indeed another folk wisdom is that the RST becomes unworkable at rates of more than 10–12 percent

...

The reasons why a VAT, levied using the credit (invoice) method, is harder to evade than a sales tax are well known. Invoices provide a good audit trail; the tax is collected at all stages of production, including imports, rather than at the retail level only; the tax puts the onus of proof for tax credits on taxpayers; cross-checking, even on a sample basis, helps income tax enforcement; better record-keeping is required; the base can be widened over time, to include more services, and to cover more items than a sales tax; and the use of invoices helps make the VAT self-enforcing to some degree, since a taxable buyer has an incentive to insist on an invoice. These advantages, while real, should not be overstated. A retail sales tax may be cheaper to administer, since there are fewer taxpayers; since it is simpler, it can also be introduced faster. The importance of collecting tax at pre-retail stages of production has been questioned, and the self-enforcing mechanism has been termed "illusory". When Sweden replaced its retail sales tax with a VAT in 1970 there was no perceptible change in the tax yield (OECD (1988), p. 103), although when a similar change was made in Ireland in 1972 an increase was observed. (citations omitted)

The bottom line is that there are many ways to evade a value added tax that do not exist in a retail sales tax and these means are routinely used by tax evaders in other OECD countries. It is hypothetically possible that a value added tax will have lower rates of evasion compared to a retail sales tax but that is certainly not clear in principle. There are as many theoretical reasons to believe a sales tax is superior as inferior to a value added tax and there is no empirical data that stands for the proposition that one is superior to another, let alone a fact-based consensus to that effect.

Retail sales taxes in the U.S. of 9 to 10 percent are routinely collected⁵⁴ but sales taxes have not been collected at rates as high as VAT rates in Europe. Any comparison of the 23

⁵⁴ Louisiana (9.98 percent), Tennessee (9.46 percent), Arkansas (9.30 percent), Alabama (9.01 percent), and Washington (8.92 percent), "State and Local Sales Tax Rates in 2017," Tax Foundation, January 31, 2017 <https://taxfoundation.org/state-and-local-sales-tax-rates-in-2017/>. DC imposes a 10 percent tax on restaurants. Many states and localities impose very high tax rates on hotels and rental cars.

percent FairTax with European VAT experience should be made with caution. European VATs are imposed at rates of 18-27 percent, comparable to the 23 percent FairTax rate.⁵⁵ But these rates are applied *in addition* to relatively high income and payroll taxes. In contrast, the FairTax replaces all income and payroll taxes. Because few tax evaders report a transaction for income tax purposes and not VAT purposes (or vice versa), it is better to compare the combined rates rather than just focus on one tax. And European combined VAT-Income-Payroll tax rates are much higher than the proposed FairTax rate.

There are tax evasion methods that are distinct to the VAT and methods that both a VAT and a sales tax share. Those distinct to a VAT include:

1. False claims for credit or refund on intermediate or export sales;
2. Credit claimed for VAT on purchases that are not creditable;
3. Bogus traders;⁵⁶ and
4. “Carousel fraud” or “Missing Trader Fraud”⁵⁷

Both a VAT and a sales tax are subject to these tax evasion methods:

1. Underreported sales;
2. Failure to register or report any sales;
3. Misclassification of taxable goods or services (where certain goods or services are exempt or subject to a lower tax rate); and
4. Tax collected but not remitted.

The question boils down to whether the ways that a VAT can be evaded or exploited but a retail sales tax cannot are outweighed by the supposed administrative advantages of a VAT. Carefully examining the reasons given for a VATs administrative superiority raises serious doubts. Keen and Smith’s list provided in the quotation above is representative. [Keen and Smith, 2007].

“Invoices provide a good audit trail.” – Such cross audits are very rarely actually undertaken and, equally importantly, could be undertaken by sales tax authority were it deemed to be productive strategy for discovering tax evasion. Section 508 of the revised

⁵⁵ VAT Rates Applied in the Member States of the European Union, January 1, 2017 https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_en.pdf.

⁵⁶ Keen and Smith, 2007 (Companies may be set up solely to generate invoices that allow recovery of VAT. Such “invoice mills” exploit the practical impossibility of crosschecking every invoice against evidence that earlier tax has been paid.)

⁵⁷ Exploiting the zero-rating of exports combined with the “deferred payment” mechanism for collecting VAT on imported goods adopted in the EU with the removal of fiscal frontier formalities in 1992. VAT refunds are collected with respect to VAT never paid. See, e.g., “How Carousel Fraud Works,” Reuters, August 20, 2009 (“The fraud has high returns over a short period of time. It is quite difficult to prove, meaning convictions are sparse. ”) <https://uk.reuters.com/article/uk-carousel-fraud-britain-factbox-sb/factbox-how-carousel-fraud-works-idUKTRE57J43U20090820> .

Internal Revenue Code proposed by the FairTax explicitly requires that the records enabling such cross audits be retained for seven years.⁵⁸

“The tax is collected at all stages of production, including imports, rather than at the retail level only.” – This is true but it is far from clear that it is actually an advantage. This is precisely why the various credit frauds in the credit invoice VATs are possible. Furthermore, a retail sales tax taxes imports when they are sold to consumers.

“The tax puts the onus of proof for tax credits on taxpayers.” – It is not entirely clear what Keen and Smith meant by this. In a sales tax, there are no credits as there are in a credit-invoice VAT so there is no need to put the “onus for tax credits” on taxpayers in a sales tax. Since 1998,⁵⁹ the U.S. income tax has provided that the government has the burden on proof in tax matters.⁶⁰ Since it was signed into law, there have been few complaints from the tax authorities or others that the provision is a major barrier to tax collection. The FairTax contains a similar provision placing the burden of production on the taxpayer but the burden of proof on the government.⁶¹ Were, however, this provision proved to be somehow inimical to tax collection, which is highly unlikely, then it could be changed without altering the structure of a sales tax.

“Cross-checking, even on a sample basis, helps income tax enforcement.” – This is rarely done in practice in the administration of European VATs and can be done by sales tax administering authorities. The FairTax clearly contemplates this possibility.

“Better record-keeping is required; the base can be widened over time, to include more services, and to cover more items than a sales tax.” – The FairTax base is broader than most, if not all, European VATs and the record-keeping requirements are comparable.

“The use of invoices helps make the VAT self-enforcing to some degree, since a taxable buyer has an incentive to insist on an invoice.” – This “self-enforcing” aspect of the VAT is precisely what causes the VAT specific and quite common means of tax evasion. Plus, the cross audits are quite rare in VAT administration and, as mentioned above, if they prove to be cost effective, FairTax enforcement authorities can undertake the cross audits because those making exempt sales must retain documentation.

⁵⁸ “Any purchaser who purchased taxable property or services but did not pay tax by reason of asserting an intermediate and export sales exemption shall keep records sufficient to determine whether said exemption was valid for a period of 7 years after the purchase of taxable property or services.”

⁵⁹ Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105–206 (1998).

⁶⁰ “If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.” Internal Revenue Code §7491.

⁶¹ Proposed Internal Revenue Code 505 (H.R. 25): “In all disputes concerning taxes imposed by this subtitle, the person engaged in a dispute with the sales tax administering authority or the Secretary, as the case may be, shall have the burden of production of documents and records but the sales tax administering authority or the Secretary shall have the burden of persuasion. In all disputes concerning an exemption claimed by a purchaser, if the seller has on file an intermediate sale or export sale certificate from the purchaser and did not have reasonable cause to believe that the certificate was improperly provided by the purchaser with respect to such purchase (within the meaning of section 103), then the burden of production of documents and records relating to that exemption shall rest with the purchaser and not with the seller.”

V. Quantitative Considerations

Any quantitative estimate with respect to tax evasion or the impact of policy changes on levels of tax evasion must be regarded as an exercise in extreme approximation. This is primarily because tax evasion is, by its nature, difficult to detect and tax evasion that is undetected by tax authorities is even more difficult for economists to estimate. There are also many factors that must be considered.

That said, two empirical studies enable an approximate estimation of the impact that the reduction in marginal tax rates under the FairTax would have on evasion. There are a number of other factors, as discussed above, that ideally should be considered and almost all of these factors would improve under the FairTax. Thus, the estimates below are very conservative and likely underestimate the actual decrease in tax evasion that adoption of the FairTax would cause.

Using Clotfelter's elasticities:⁶²

Table 8
Impact of the FairTax on The Magnitude of the Tax Gap

A	B	C	D	E	F	G	H	I	J
Types of Income	Elasticity of Under-reported AGI wrt Marginal Tax Rate ⁶³	Relevant Tax Gap (\$ billions)	Under-reported Income ⁶⁴	Current Marginal Tax Rate	FairTax Marginal Tax Rate	Change in Marginal Tax Rate (%) ⁶⁵	Change in Under-reported income /consumption (%) ⁶⁶	Change in Under-reported income /consumption (\$ billions) ⁶⁷	Change in Tax Gap (\$ billions) ⁶⁸
Non Business	0.844	238 ⁶⁹	650	0.366 ⁷⁰	0.23	-37.2	-31.4	204	47
Non-Farm Business	0.515	119 ⁷¹	321	0.371 ⁷²	0.23	-38.0	-19.6	23	5
Farms	0.770	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

⁶² See Table 2, p 369.

⁶³ From Clotfelter, 1983.

⁶⁴ Assuming the underreported income would be subject to tax at the marginal tax rate. Ergo, the tax gap divided by the marginal tax rate is the underreported income amount. Column C / E.

⁶⁵ Column F / E - 1.

⁶⁶ Column G * B.

⁶⁷ Column H * D.

⁶⁸ 23 percent of the change in underreported income. Column F * I.

⁶⁹ Individual income tax (non-filing gap), non-business income (underreporting gap), and individual income tax (underpayment gap) from Table 1 above.

⁷⁰ Income and payroll taxes; see discussion above.

⁷¹ Using self-employment tax (non-filing gap), business income (underreporting gap), self-employment tax (underreporting gap), corporation income tax (underreporting gap), and corporation income tax (underpayment gap) from Table 1 above.

⁷² Using marginal income tax rate for top ten percent plus a very conservative 3.8 percent payroll tax rate (i.e. assuming all business income is above the Social Security wage base). $0.333 + 0.038 = 0.371$. See Table C.2. in Saez, 2004 for top ten percent marginal tax rates.

Based on elasticities reported by Clotfelter, the marginal tax rates reductions caused by adoption of the FairTax can be expected to reduce the tax gap by \$52 billion. Since current tax gap is \$406 billion, this means a 12.8 percent reduction in the size of the tax gap.

Boylan et al., 2014 report an elasticity of the maximum federal marginal tax rate with respect to tax evasion of 0.28.

Table 9
Impact of the FairTax on the Magnitude of the Tax Gap

A	B	C	D	E	F
Non-Corporate Tax Gap	Elasticity of Tax GAP wrt Marginal Tax Rate	Current Marginal Tax Rate	FairTax Marginal Tax Rate	Change in Marginal Tax Rate (%)	Change in Tax Gap (\$ billions) ⁷³
362	0.28	0.366	0.23	-37.2	-37.7

Based on the elasticity reported by Boylan et al, the marginal tax rates reductions caused by adoption of the FairTax can be expected to reduce the tax gap by \$38 billion. Since current tax gap is \$406 billion, this means a 9.4 percent reduction in the size of the tax gap.

VI. Conclusion

The FairTax can be expected to substantially reduce tax evasion. The empirical literature finds that marginal tax rates have an important impact on tax evasion and the FairTax would substantially reduce tax rates. Based on this factor alone, the FairTax can be expected to reduce the tax gap by \$38 to \$52 billion annually (i.e. by 9.4 percent to 12.8 percent).

Other factors suggest that the FAIRtax will likely reduce the tax gap by more than 9 to 13 percent but lack of data prevents them from being quantified. The FairTax dramatically reduces the number of collection points in the tax system and effectively imposes a withholding tax at the point of sale. Both factors will improve compliance. Approximately 3 ½ percent of all businesses (those with annual receipts of \$10 million or more) would account for about 86 percent of total retail sales. The FairTax would reduce the number of tax return filers by approximately 94 percent and, given a certain amount of administrative resources, significantly increase audit rates for filers. Complexity increases evasion and the FairTax dramatically reduces complexity. Lastly, reported evasion in consumption taxes (both sales taxes and value added taxes) are substantially lower than with income taxes.

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⁷³ Column A * B * E.

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